Internal Revenue Service

memorandum

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Br5:MGillmarten

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to: George Vukovich, Appeals Officer, Los Angeles, CA

from: Chief, Branch 5, Office of Associate Chief Counsel (International)

subject: [redacted]

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This memorandum responds to your request for informal assistance on the examination of [redacted] or Taxpayer) and subsidiaries. The facts of the case are still unsettled. We have had several telephone conversations with the Appeals Officer previously assigned to the case, attempting to clarify certain questions. Despite the need for additional factual development, we have some preliminary thoughts that should be useful.

FACTS

[redacted] is a domestic corporation that owns, manages and operates [redacted] and was involved in the development of additional [redacted] and implementation of [redacted] for clients including city, county, religious, non-profit and for profit [redacted] facilities. [redacted] owns [redacted] percent of [redacted] and [redacted] percent of [redacted], both domestic corporations. [redacted] owns [redacted] percent of [redacted], hereinafter [redacted].

[redacted] was incorporated in the [redacted] in [redacted]. In [redacted] had owned a [redacted] in [redacted] for several years and received revenues from leasing that facility. Although [redacted] concedes it has no employees, the characterization of the leasing income is not

in dispute. [redacted] and [redacted], a [redacted] Company, entered into a contract to establish a [redacted] partnership: [redacted][1]. [redacted] operates and maintains [redacted] and [redacted] in the [redacted] Taxpayer's [redacted], memo to you seems to indicate that it sought a direct affiliation with a [redacted] corporation and simply used [redacted] as the vehicle for that association.

Taxpayer represents that [redacted] has a [redacted] percent capital interest in [redacted] and [redacted] has a [redacted] percent capital interest. On the other hand, under a profit distribution agreement (Profit Distribution Agreement) between [redacted] and [redacted], [redacted] received a [redacted] percent net profits interest in consideration of [redacted]'s substantially greater executive, managerial and technical assistance to the partnership. [redacted] received the remaining [redacted] percent interest. This agreement contradicts Taxpayer's position that it is only a passive investor in [redacted]; Taxpayer fails to account for the discrepancy.[2]

[redacted] entered into three other agreements: a recruiting agreement and a purchasing services agreement with [redacted], and a technical assistance agreement with [redacted]. Under the recruiting agreement, [redacted] agreed to conduct a worldwide search to recruit [redacted] personnel to staff [redacted] managed in [redacted]. Under the purchasing services agreement, [redacted] agreed to purchase equipment and supplies for [redacted] to use in its management of the [redacted].

Under the recruiting and purchasing agreements, direct costs of recruiting, equipment, and supplies were charged directly to the respective contract, while all overhead incurred by [redacted] in providing the services was allocated between the [redacted] contracts. [redacted] employed recruiting specialists and materials

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[1]The analysis differs if [redacted] is not a partnership. See the enclosed memorandum, especially pp. 4-9. We do not know whether the IE raised the classification issue.

[2]The facts and circumstances surrounding the Profit Distribution Agreement should be developed, if possible.

management specialists who performed their services for [redacted] out of [redacted]'s office in [redacted].

[redacted] agreed, in return, to reimburse [redacted] for all direct costs incurred in connection with the rendering of services, and to pay [redacted] an amount equal to an approximation of [redacted]'s overhead and other indirect costs attributable to the services. Such fees were payable on demand. Neither agreement contained a provision for a profit margin for [redacted].

Under the technical assistance agreement, [redacted] agreed to provide systems and other assistance in the staffing, management, operation and maintenance of [redacted] in various locations throughout the world in return for stated monthly fees payable by [redacted]. These fees increased and decreased with the level of assistance requested by [redacted] during the years at issue.

Proposed adjustments for tax years ending in [redacted] and [redacted] were based on alternative theories: 1) that [redacted] is a sham corporation; 2) section 954(e) foreign base company services income; and 3) section 482 reallocation of [redacted]'s income.

Under the Profit Distribution Agreement, [redacted] received substantial sums of money in return for [redacted]'s "substantial contribution" of expertise and assistance. However, [redacted] has no employees. Because [redacted] has owned a [redacted] in [redacted] for several years and has received rental income from that [redacted], a sham argument does not appear to be practicable.

DISCUSSION

Based on the information available to us, it appears reasonable to reallocate, under section 482 of the Code, the amounts received by [redacted] under the Profit Distribution Agreement among the related parties who actually performed the services or, in the alternative, to treat the distribution as subpart F income.

Section 482

Section 482 of the Code authorizes the Secretary to distribute, apportion or allocate gross income, deductions, credits or allowances among related parties to prevent evasion of taxes or to clearly reflect income. The regulations adopt the concept of the arm's length standard as the method of determining whether reallocations are appropriate, generally, by identifying the respective amounts of taxable income of the related parties that would have resulted if they had been uncontrolled parties dealing at arm's length.[3] Section 1.482-1(b).

The regulations provide rules for determining the arm's length charge for services when no property transfer is involved.[4] An appropriate charge may be cost reimbursement (no profit to the service provider). However, cost reimbursement is not appropriate where the services are an integral part of the business activity of either the member rendering the services or the member receiving the benefit of the services. Section 1.482-2(b)(3). Situations where services are an integral part of the business activity of a member of a controlled group include where (i) either the renderer or the recipient is engaged in the trade or business

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[3]Taxpayer confuses the issue in its Protest by asserting that if §482 is applied to reallocate [redacted]'s income to [redacted], then the requisite control under §482 does not exist. The Service is not suggesting such a reallocation. Rather it is reallocating [redacted]'s income to entities that control it, [redacted] and [redacted]. Therefore, Taxpayer's control argument is simply a diversion.

[4]You may find that an actual transfer of intangibles occurred. For example, [redacted] may have transferred an intangible in the form of a "system", its management expertise and experience, to [redacted]. See, Hospital Corporation of America, 81 T.C. 520, 599 (1983). If a transfer occurred section 367 might apply. See generally, Hospital Corporation of America at page 587. If the transfer occurred after December 31, 1984, it would be treated as notional contingent sale and amounts attributable to the sale are treated as U.S. source income. See, 1.367(d)-1T.

of rendering similar services to one or more unrelated parties and (ii) the renderer is peculiarly capable of rendering the services and such services are a principal element in the operations of the recipient. Section 1.482-2(b)(7).

Cost reimbursement should not be an appropriate charge in this case because the services appear to be an integral part of the business activity of [redacted] and [redacted]. Under the facts as we understand them, [redacted] and [redacted] are in the trade or business of rendering services to unrelated parties similar to the services they rendered to [redacted]. Additionally, [redacted] and [redacted] seem to be peculiarly capable of rendering services that are a principal element in the operations of [redacted]. It appears that [redacted] and [redacted] are in the business of providing the services listed in their contracts with [redacted] and it is those services that are the principal element in the operations of [redacted] with respect to its participation in the joint venture with [redacted].

Under the Profit Distribution Agreement, [redacted] receives [redacted] percent of the net profits from [redacted] in return for services.[5] However, [redacted] has no employees to perform any services. If [redacted], a related party, provided services and equipment and received only cost reimbursement,[6] reallocating that portion of [redacted]'s distribution to reflect an arm's length charge for services under section 482 seems appropriate.[7] Similarly, if the fees

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[5]Some percentage of the distribution to [redacted] may be a return on contributed capital. However, it appears that the capital contributed by [redacted] was minimal. If this is so, then substantially all of the distribution to [redacted] is attributable to services, or use of intangibles.

[6][redacted] is a subsidiary of [redacted] and a sister corporation to [redacted], the parent of [redacted]. Thus, the applicable related parties for this argument are [redacted], [redacted], and [redacted]; we are not asserting that [redacted] and [redacted] are related to [redacted].

[7]Unfortunately, we have no information regarding market value of the services provided and whether the contracts reflect common industry practice.

paid to [redacted] do not reflect arm's length pricing, reallocation under section 482 is appropriate.[8]

In the case of intangibles, a reallocation can be made when intangible property or an interest in the property is made available to a related party for other than an arm's length consideration. Section 1.482-2(d)(1). Intangible property includes processes, designs, trademarks, trade names, methods, programs, systems, procedures, surveys, studies, forecasts, estimates, technical data, and similar items. Section 1.482-2(d)(3).

In the contract for technical services with [redacted] "Technical Assistance" is not clearly defined, but the Agreement makes reference to [redacted] experience in providing "systems and other assistance in the staffing, managing, operation and maintaining of [redacted]...." The Addenda to the original Agreement indicate that the cost of such services went up in the first years but then decreased as [redacted] developed its own expertise in this area. As mentioned previously, the use of management expertise and experience in the form of a system is intangible property.[9]

Subpart F

As an alternative argument, the profit distribution received by [redacted] may be subject to current U.S. tax under subpart F of the Code. Generally, under subpart F

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[8]In its [redacted], Letter of Protest and Request for Appeals' Consideration, Taxpayer concedes that [redacted]'s activities with respect to [redacted] were "minimal, since, as a passive investor in [redacted], nothing was required of [redacted]." Taxpayer believes this resolves the section 482 issue. On the contrary, it brings into sharper focus the discrepancy inherent in the profit distribution to [redacted] and its alleged investment in [redacted] (see footnote 5). All three agreements and available comparables should be carefully analyzed to determine the extent to which the distribution received by [redacted] really constitutes reimbursement for services, or use of intangibles, provided by a related party (i.e., [redacted] and [redacted]).

[9]See, Hospital Corporation of America, in footnote 4.

principles, the characterization for subpart F purposes of a controlled foreign corporation's (CFC) partnership distribution is determined by reference to the characterization of the income of the partnership as if earned directly by the CFC. See Rev. Rul. 89-72, 1989-1 C.B. 257.[10] We understand that [redacted] earns income from the operation of [redacted] in [redacted], is paid by the [redacted], and then makes a distribution to [redacted].

Under section 951 of the Code a U.S. shareholder [redacted] of a CFC [redacted] includes in gross income its pro rata share of subpart F income. Subpart F income includes foreign base company services income as defined in section 954(e). Foreign base company services income includes income from the performance of certain technical, managerial, skilled, commercial or like services which are performed (i) for or on behalf of any related person (within the meaning of section 954(d)), and (ii) outside the CFC's country of incorporation.[11]

A related person for purposes of section 954(d)(3) of the Code includes a corporation that controls a CFC, or a corporation that is controlled by the same person or persons that control the CFC. [redacted], as sole shareholder of [redacted] controls [redacted]. [redacted], as sister corporation to [redacted], is controlled by the same U.S. parent [redacted] that controls [redacted]. Therefore, both [redacted] and [redacted] are related to [redacted].

The services of a CFC will be treated as performed for, or on behalf of, a related person if, for example, a party related to the CFC furnishes substantial assistance to the CFC in connection with the provision of services. Section 1.954-4(b)(1)(iv). Assistance includes, but is not limited to, direction, supervision, services, know-how, equipment, material or supplies. Assistance is substantial if the assistance is a principal element in producing the income from the performance of services by the CFC, or if such assistance

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[10]For purposes of the following discussion only, we have assumed that [redacted] is a partnership.

[11]We assume no services are performed in the [redacted].

assists the CFC directly in the performance of the services for which the CFC is compensated.

Example 2 in section 1.954-4(b)(3) of the regulations illustrates substantial assistance resulting in foreign base company services income. In Example 2, CFC B enters into a contract with an unrelated person to provide services in a foreign country. B employs a small clerical and administrative staff and owns the equipment necessary to provide the contracted services. Most of the technical and supervisory personnel are regular employees of U.S. shareholder M, who are temporarily employed by B. In addition, B hires on the open market, unskilled and semi-skilled laborers to work on the project. The example concludes that the services performed by B under the contract are foreign base company services income because the services of the technical and supervisory personnel provided by M are of substantial assistance in the performance of such contract. They assist B directly in the execution of the contract and provide B with skills which are a principal element in producing income from the performance of such contract.

[redacted] is ostensibly compensated for services it provides to [redacted] under the Profit Distribution Agreement. [redacted] has no employees and owns no equipment, nor did [redacted] hire anyone on the open market to provide services to [redacted]. As we understand the facts, [redacted] and [redacted] are the only parties that could provide substantial assistance enabling [redacted] to perform "executive, managerial, and technical assistance" to [redacted] for which [redacted] received a profits interest. Also, the assistance provided by [redacted] and [redacted] seemingly is the principal element in producing the service income and assists [redacted] directly in the performance of the services for which [redacted] receives compensation under the Profit Distribution Agreement.[12]

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[12] Although [redacted] has no employees, it has been in existence for several years and has reported income from its rental property in the [redacted], so [redacted] probably cannot be shammed. However, [redacted] is being paid for something, either its "connections" with [redacted], [redacted], and [redacted], or as part of a tax avoidance scenario.

Under this analysis, the income is foreign base company services income because related parties [redacted] provided substantial assistance to [redacted] (a CFC) in connection with the provision of services. This amount is includable currently in the income of the U.S. shareholder, [redacted].[13]

Characterizing income of [redacted] as foreign base company income essentially accomplishes the same result as reallocating its income under section 482. Both result in income being subject to U.S. tax currently. In effect, subpart F acts as a backstop to section 482.[14]

It appears that further factual development is required to quantify an arm's length charge under section 482. We believe the subpart F argument is strong and may prove a reasonable alternative to the reallocation under section 482. In any event, it should facilitate settlement discussions with the Taxpayer. If you have any further questions, please call Mary Gillmarten at FTS 566-6284

Robert Katcher

Robert Katcher

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[13]Note that the income will not be currently includible if the income meets the test under section 954(b)(4). See accompanying memo on p. 9.

[14]Section 707(a) may provide a simpler argument. Section 707(a), effective for the years at issue, provided that if a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall be considered as occurring between the partnership and one who is not a partner. There are certain exceptions provided in the statute. We have not coordinated this issue with the Domestic offices having jurisdiction over §707, but will be happy to do so it you think it will further the case.